



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended	04/30/02	Bill No:	SB 1701
Tax:	Cigarette and Tobacco Products	Author:	Peace
Board Position:	Support	Related Bills:	

BILL SUMMARY

This bill would, as of January 1, 2005, require the State Board of Equalization (Board) to replace the stamps and meter impressions, currently required to be affixed to a package of cigarettes, with stamps and meter impressions generated by a technology capable of being read by a scanning or similar device, and encrypted with specified information.

ANALYSIS

Current Law

Revenue and Taxation Code Section 30161 (Cigarette and Tobacco Products Tax Law) generally provides that the cigarette tax imposed with respect to the distribution of cigarettes shall be paid by distributors through the use of stamps or meter impressions. Stamps and meter impressions, pursuant to Section 30162, shall be of such designs, specifications and denominations as may be prescribed by the Board.

Proposed Law

This bill would amend, repeal and add Section 30162 to require the Board, as of January 1, 2005, to replace stamps and meter impressions, currently required to be affixed to a package of cigarettes prior to distribution as evidence of payment of the tax imposed, with stamps and meter impressions that can be read with a scanning or similar device. This bill would require the stamps and meter impressions to be encrypted with, at a minimum, the following information:

- The name and address of the wholesaler or distributor affixing the stamp or meter impression.
- The date the stamp or meter impression was affixed.
- The denominated value of the stamp or meter impression.

REVISED COST ESTIMATE

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

Background

The Board currently contracts with The Meyercord Company (Meyercord) for cigarette tax stamps and application machinery. Among other things, the contract provides the denominations and configurations of stamps, design of stamps, performance of stamps, security, inventory system, and requirements for application machinery, ancillary equipment, service and training. The cigarette tax stamp contract is for the three-year period commencing January 1, 2002 and ending December 31, 2004. With respect to counterfeit stamps, the contract provides the following:

- Stamps shall be designed so that the date of issuance and denomination can quickly be determined upon unaided visual inspection of stamps affixed to packages of cigarettes.
- Stamps shall contain hidden security features that will allow staff of both the Board and the bidder to determine their authenticity.
- Bidder shall provide specifications using the most effective technology that would contain security features to prevent counterfeit or reproduction of stamps.
- Stamps shall be constructed in layers consisting of at least five impressions, including safety-tint letter, applied to a release type carrier using a gravure process.
- Each stamp shall contain not less than three different distinctive colors.
- All stamps on rolls shall be numbered to provide a means to trace both affixed and unaffixed stamps in the case of fraud, theft, or loss.

Stamps ordered by the Board are furnished by Meyercord to Bank of America. The Board contracts with Bank of America to sell cigarette tax stamps to licensed distributors and to remit the tax collected to the Board. The Board's current contract with Bank of America is for the three-year period commencing July 1, 2001 and ending June 30, 2004.

Licensed cigarette distributors affix the cigarette stamps to packages of cigarettes with machinery purchased or leased from Meyercord. The packages of cigarettes are generally distributed by cigarette distributors to retailers and wholesalers in this state.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by Senator Peace and is intended to require the Board to use a "smart" cigarette tax stamp capable of storing a unique, encrypted digital signature. The author believes that a smart cigarette tax stamp would address the counterfeit tax stamp issue where stamps are reproduced and appear identical to legitimate indicia. The authenticity of the tax stamp could be verified visually and with a hand held scanning device.
2. **Summary of amendments.** The introduced version would, on or before January 1, 2005, have required the Board to replace the stamps and meter impressions, currently required to be affixed to tobacco products, with a two-dimensional (2-D) bar

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code stamp that can be read with an existing scanning device. The April 30, 2002, version of the bill addresses the Board's concern with respect to limiting the Board to the 2-D barcode stamp by instead allowing the use of other technology that would generate stamps and meter impressions capable of being read by a scanning or similar device. The bill also clarifies that stamps are only affixed to cigarettes as evidence of payment of the tax, and not tobacco products.

3. **This measure would provide investigators a method of instantly verifying the authenticity of a stamp.** The Board's Investigations Division has identified several evasion schemes involving counterfeit cigarette stamps. Production methods of such stamps include, in part, offset printing, silkscreen, lithography, flexo printing, laser printing and personal computer. Currently, counterfeit stamps are typically of such good quality that they appear identical to an authentic stamp therefore making it virtually impossible to identify counterfeit stamps by visual inspection.

This bill would address the identification of counterfeit stamps by requiring the use of a stamp that is capable of being read by a scanning or similar device. Each stamp would be a unique, encrypted digital signature. An on-site decryption through the use of a scanning or similar device would instantly reveal the unique digital signature, which would verify the authenticity of the stamp. A duplicate or wrong message would indicate a counterfeit stamp.

4. **New process would eliminate the need for bank contract.** The purchase process of encrypted stamps, as Board staff understands, would begin with the distributor placing an order for stamps with the Board. The Board would subsequently notify the stamp vendor of the order. The stamp vendor would create the stamp and deliver it electronically to the distributor's digital stamping equipment. As a result of this measure, Bank of America's role of selling stamps to licensed distributors would no longer be necessary since the stamp would be delivered directly from the vendor to the distributor electronically. The Board's contract with Bank of America currently costs California approximately \$586,000 per year. This would also address the Department of Finance's interest in reducing or eliminating these contract costs.

COST ESTIMATE (Revised)

The Board would incur start-up costs related to the testing, operation and evaluation of stamps and meter impressions (including security features and machine application), notifying licensed distributors, developing returns, revising forms and publications, and computer programming. These costs are estimated as follows:

	<u>2002-03</u>	<u>2003-04</u>	<u>2004-05</u>
Personal Services ¹	\$57,000	\$109,000	\$308,000
<u>OE & E²</u>	<u>257,000</u>	<u>484,000</u>	<u>658,000</u>

¹ Permanent positions, overtime and temporary help

² Operating expense and equipment related to positions, as well as resources for processing, reprogramming, and notifying tax payers.

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Total	<u>\$314,000</u>	<u>\$593,000</u>	<u>\$966,000</u>
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Beginning July 1, 2005 and each fiscal year thereafter, it is estimated that the Board would incur on-going costs of approximately \$264,000 to implement the provisions of this measure.

These estimated costs do not include the vendor cost to produce the cigarette tax stamps, beginning January 1, 2005, because the costs are unknown at this time. Also, these estimated costs do not recognize the elimination of the Board's contracts with Meyercord to produce cigarette tax stamps (approximately \$700,000 annually) and Bank of America to sell stamps (approximately \$586,000 annually). The Meyercord contract is due to expire December 31, 2004 and the Bank of America contract is due to expire June 30, 2004. It would be necessary to extend the Bank of America contract for the period of July 1, 2004 through December 31, 2004.

REVENUE ESTIMATE

The provisions of this bill should have a positive impact on the state excise tax collected due to decreased evasion related to counterfeit cigarette tax stamps. However, the Board has no way of measuring the potential impact these provisions may have, and therefore, cannot provide an estimate at this time.

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